Internal Revenue Service

memorandum

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to: Margaret Rigg
District Counsel, San Francisco

from: Senior Technical Reviewer, Branch 1
Office of Associate Chief Counsel (International)

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subject: [redacted] -- SECTION 482 SERVICES INCOME

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The following information is submitted in response to your inquiry as to whether a "cost plus" fee must be paid by subsidiaries of [redacted] for services performed for the subsidiaries' benefit by [redacted]. In particular, this memorandum addresses the issue of whether [redacted] is "peculiarly capable" of providing services to [redacted]'s subsidiaries, for the purpose of determining whether [redacted] is an "integral part" of the subsidiaries' business, within the meaning of Treas. Reg. § 1.482-2(b)(7).

Facts

[redacted] is a wholly-owned, domestic subsidiary of [redacted]. The two corporations file consolidated tax returns. [redacted]'s function is to provide onshore services for [redacted]'s [redacted] foreign shipping subsidiaries. The foreign shipping subsidiaries normally conduct offshore operations involved in transporting [redacted] oil. [redacted]'s activities include (1) engineering design of naval architecture and construction of vessels; (2) repair and maintenance of fleets; (3) scheduling, procurement, and disposition of vessels; (4) arranging supplies for the fleet, negotiating and administering labor agreements for the fleet, arranging port activities, and supplying shore equipment and facilities for the fleet, and (5) legal and accounting services.

The foreign subsidiaries pay [redacted] a fee equal to the cost of the services provided. [redacted] argues that it need not charge the subsidiaries a fee equal to its cost plus a mark-

up because it is not an "integral part" of the subsidiaries' business, within the meaning of Treas. Reg. § 1.482-2(b)(7). However, the International Examiner believes that [redacted] is not receiving an "arm's length" fee for its services, and has proposed making an allocation of income from the foreign subsidiaries to [redacted].

Discussion

Under Treas. Reg. § 1.482-2(b),

> Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph, the district director may make appropriate allocations to reflect an arm's length charge for such services.

In subparagraph (3), which defines an arm's length charge for services, the regulations state

> except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services (as described in subparagraph (7) of this paragraph), the arm's length charge shall be deemed equal to the costs or deductions incurred . . . (emphasis added).

In light of the regulations cited above, one may conclude that the fee charged by [redacted] to the foreign subsidiaries was an arm's length fee (i.e., cost), unless the services of [redacted] were "an integral part of the business activity" of [redacted] or of the subsidiaries.

The regulations provide four tests to determine whether services are an integral part of the business activity of a member of a controlled group. Services are considered an "integral part" when (1) either the renderer or the recipient is engaged in the trade or business of rendering similar services to unrelated parties; (2) the renderer renders services to one or more related parties as one of its principal activities; (3) the renderer is peculiarly capable of rendering the services and the services are a principal element in the operations of the recipient; or (4) the recipient has received the benefit of a substantial amount of services from one or more related parties during

its taxable year.

According to the information provided, [redacted] fails tests (1), (2) and (4) above; that is, [redacted]'s services to the subsidiaries would not be considered an integral part of the business activity of [redacted] or of the subsidiaries under any of those tests. With regard to test (1), there is no indication in the Examiner's report that either [redacted] or the subsidiaries provided similar services to unrelated parties. Under the second test, found in Treas. Reg. § 1.482-2(b)(7)(ii), it is presumed that the renderer does not render services to related parties as one of its principal activities if the costs of services rendered for related parties do not exceed 25% of the total costs or deductions of the renderer. For the purpose of this test, a consolidated group may, at the option of the taxpayer, be considered as the renderer. According to the Examiner, [redacted] has claimed that, under test (2), its shipping activities would not be considered one of the "principal activities" of the renderer, since it would elect for the [redacted] consolidated group to be treated as the renderer. The Examiner believes that the consolidated group's financial data support [redacted]'s position. Finally, it is presumed that since the Examiner's report is silent on this issue, [redacted] would fail test (4). This test, found in Treas. Reg. § 1.482-2(b)(7)(iv), determines whether a recipient of services provided by related parties has received services equal to more than 25% of the recipient's own costs or deductions. If so, the services of the rendering parties will be considered services which are an integral part of the business activity of the rendering parties. In consequence, the rendering parties would be required to charge a "cost-plus" fee for those services.

To summarize, an arm's length charge for services performed by members of a controlled group for each other is generally deemed to be the cost of those services to the renderer. However, when services performed for a related party are an "integral part" of the business activities of the renderer or the recipient, an arm's length charge for those services will be equal to the renderer's cost plus an ordinary mark-up. According to the information provided, [redacted]'s services to the foreign subsidiaries do not qualify, under three of the tests mentioned above, as services which are an integral part of the activities of a member of the related group. Before discussing the final test, however, it should be emphasized that the conclusions reached above (i.e., [redacted]'s services fail three of the tests) are based on little actual data. Data with regard to [redacted]'s services should be carefully reviewed in order to ensure that the

services do not meet the tests found in Treas. Reg. § 1.482-2(b)(7)(i), (ii) and (iv).

The fourth test of whether or not services provided to a related party may be considered an integral part of the business activities of the renderer or the recipient is found in Treas. Reg. § 1.482-2(b)(7)(iii). The regulation states that

> [s]ervices are an integral part of the business activity of a member of a controlled group where the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient. The renderer is peculiarly capable of rendering the services where the renderer, in connection with the rendition of such services, makes use of a particularly advantageous situation or circumstance such as by utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property . . . However, the renderer will not be considered peculiarly capable of rendering services unless the value of the services is substantially in excess of the costs or deductions of the renderer attributable to such services.

Additional information about the meaning of "peculiarly capable" may be gleaned from explanatory materials issued with the regulation (Preamble to T.D. 6998, January 14, 1969). These materials note that in order for a renderer to be "peculiarly capable" of rendering services, the services must be "of such a nature that they are not generally available elsewhere and, although not necessarily substantial in terms of the total activities of an entity, are a key factor in determining the success or failure of a particular profit making activity."

The explanatory materials further describe each of the attributes which, according to the regulations, make an entity peculiarly capable of rendering services. "Utilization of special skills and reputation" is "intended to cover situations in which an individual . . ., because of the possession of a special skill or talent, enjoys an outstanding reputation causing his services to command a premium." The combination of special skills and reputation might, for instance, make an individual in the entertainment industry peculiarly capable of rendering services.

"Utilization of an influential relationship with customers" is not intended to describe an ordinary

purchaser-vendor relationship. The explanatory materials note that the relationship must be "particularly advantageous." Such a relationship could exist, for instance, between an automobile finance company and a life insurance agent (see Example (10), Treas. Reg. § 1.482-2(b)(7)(v)). However, such a relationship does not exist when the services rendered are merely "supporting in nature" and do not constitute a principal element in the operations of the recipient. For instance, the accounting services provided by a manufacturing firm to a related distributor would not be deemed to be rendered by a "peculiarly capable" firm, even though the manufacturer would be more familiar with the distributor's business, and therefore would be able to render accounting services more efficiently than would an unrelated person (see Example (14), Treas. Reg. § 1.482-2(b)(7)(v)).

The explanatory materials indicate that the third peculiarly advantageous situation or circumstance listed under Treas. Reg. § 1.482-2(b)(7)(iii), "utilization of intangible property," applies to "those situations in which the recipient of services, by virtue of the rendition of the services, enjoys the value of certain intangible property possessed by the renderer although the property or an interest therein is not transferred to the recipient." Examples (11), (12, and (13) of Treas. Reg. § 1.482-2(b)(7)(v) describe situations in which the drafters intended for the provision to be applied.

Finally, the explanatory materials note the importance of the last clause of Treas. Reg. § 1.482-2(b)(7)(iii): In order for a renderer to be considered "peculiarly capable," the value of services rendered must be substantially in excess of the costs or deductions of the renderer attributable to such services. According to the explanatory materials, "[i]t was generally agreed that a value of 200 percent in excess of cost is substantial while a value of 20 percent in excess of cost is not substantial. It was further agreed, however, that no one figure can be prescribed for this purpose . . . It is believed that a vast majority of cases will fall clearly on one side or the other side of 'substantially in excess' without the need for precise valuation."

In our opinion, the facts supplied lead to the conclusion that the services provided by [redacted] for the foreign shipping subsidiaries of [redacted] were not an integral part of the business activity of a member of a controlled group; the facts do not suggest that [redacted] was "peculiarly capable" of rendering shipping services. [redacted] s services were services

generally available elsewhere. The managerial, naval design and accounting services provided by [redacted] could be procured by [redacted]'s foreign subsidiaries from unrelated organizations. Moreover, it appears that [redacted]'s services were "supporting in nature." While [redacted] might have provided services to the subsidiaries more efficiently than an unrelated party could provide such services, [redacted] did not have the sort of "influential relationship with customers" described by the regulations. Nor does it appear that the subsidiaries received the benefit of unique intangible property owned by [redacted]. Finally, there is no evidence that the value of [redacted]'s services was "substantially in excess" of the costs or deductions of [redacted] attributable to those services.

Conclusion

While the transportation of oil is obviously an important activity of the [redacted] group, we doubt that the functions performed by [redacted] are an "integral part of the business activity of a member of a controlled group" within the meaning of Treas. Reg. § 1.482-2(b)(7). It does not appear that [redacted] is "peculiarly capable" of rendering the services that it performs for [redacted]'s foreign subsidiaries. It also does not appear that [redacted]'s services are an integral part of the group's business activity under one of the "twenty-five percent" rules found in Treas. Reg. 1.482-2 (ii) and (iv). Therefore, it seems that [redacted]'s charges for its services (i.e., the costs of those services) are arm's length charges.

If you have any questions, please call Lisa Grogan at FTS 287-4851.

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